ACE Limited

2005
Annual Report

PERSPECTIVE INSIGHT **CLARITY** **ACTION**

Our reinsurance recoverable on unpaid losses and loss expenses increased in 2005, primarily due to catastrophe losses which added approximately $1.4 billion to the balance. This impact was partially offset by the novation of approximately $600 million of reinsurance recoverable on unpaid losses and loss expenses as intended under our 1999 agreement in connection with the purchase of CIGNA's P&C businesses. During 2005, we wrote-off approximately $130 million of reinsurance recoverable on unpaid losses and loss expenses (and associated provision for uncollectible reinsurance of the same amount) which we believe to be uncollectible. This action had no impact on our net income.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

Liquidity is a measure of a company's ability to generate cash flows sufficient to meet short-term and long-term cash requirements of its business operations. As a holding company, ACE Limited possesses assets that consist primarily of the stock of its subsidiaries, and of other investments. In addition to net investment income, our cash flows currently depend primarily on dividends or other statutorily permissible payments. Historically, these dividends and other payments have come from our Bermuda-based operating subsidiaries, which we refer to as our Bermuda subsidiaries.

As an insurance company, one of our principal responsibilities to our clients is to ensure that we have ready access to funds to settle large unforeseen claims. Given anticipated growth in premiums and a lengthening of the average duration of our claim liabilities due to a higher proportionate growth in long-tail relative to short-tail business, we expect that positive cash flow from operations (underwriting activities and investment income) will be sufficient to cover cash outflows under most loss scenarios through 2006. To further ensure the sufficiency of funds to settle unforeseen claims, we hold a certain amount of invested assets in cash and short-term investments and maintain available credit facilities (see section entitled, "Credit Facilities", below). In addition, for certain insurance, reinsurance, or deposit contracts that tend to have relatively large and reasonably predictable cash outflows, such as loss portfolio contracts, we attempt to establish dedicated portfolios of assets that are duration-matched with the related liabilities. With respect to the duration of our overall investment portfolio, we manage asset durations to both maximize return given current market conditions and provide sufficient liquidity to cover future loss payments. In a low interest rate environment, the overall duration of our fixed maturity investments tends to be shorter and in a high interest rate environment, such durations tend to be longer. Given the current low-rate environment, at December 31, 2005, the average duration of our fixed maturity investments (2.9 years) is less than the average expected duration of our insurance liabilities (4.0 years).

Despite our safeguards, if paid losses accelerated beyond our ability to fund such paid losses from current operating cash flows, we might need to either liquidate a portion of our investment portfolio or arrange for financing. Potential events causing such a liquidity strain could be several significant catastrophes occurring in a relatively short period of time or large scale uncollectible reinsurance recoverables on paid losses (as a result of coverage disputes, reinsurers' credit problems or decreases in the value of collateral supporting reinsurance recoverables). Additional strain on liquidity could occur if the investments sold to fund loss payments were sold at depressed prices. Because each subsidiary focuses on a more limited number of specific product lines than is collectively available from the ACE group of companies, the mix of business tends to be less diverse at the subsidiary level. As a result, the probability of a liquidity strain, as described above, may be greater for individual subsidiaries than when liquidity is assessed on a consolidated basis. If such a liquidity strain were to occur in a subsidiary, we could liquidate a portion of the portfolio as well as be required to contribute capital to the particular subsidiary and/or curtail dividends from the subsidiary to support holding company operations.

The payments of dividends or other statutorily permissible distributions from our operating companies are subject to the laws and regulations applicable to each jurisdiction, as well as the need to maintain capital levels adequate to support the insurance and reinsurance operations, including financial strength ratings issued by independent rating agencies, which are discussed below. During 2005, we were able to meet all of our obligations, including the payment of dividends declared on our Ordinary Shares and Preferred Shares, with our net cash flow and dividends received. Should the need arise, we generally have access to the capital markets (which we accessed in 2005, refer to "Capital Resources" for more information) and other available credit facilities.

We assess which subsidiaries to draw dividends from based on a number of factors. Considerations such as regulatory and legal restrictions as well as the subsidiary's financial condition are paramount to the dividend decision. The legal restrictions on the payment of dividends from retained earnings by our Bermuda subsidiaries are currently

satisfied by the share capital and additional paid-in capital of each of the Bermuda subsidiaries. During 2005, ACE Bermuda and ACE Tempest Life Reinsurance Ltd declared and paid dividends of $548 million and $32 million, respectively. During 2004, ACE Bermuda and ACE Tempest Life Reinsurance Ltd declared and paid dividends of $227 million and $259 million, respectively. We expect that a majority of our cash inflows in 2006 will be from our Bermuda subsidiaries.

The payment of any dividends from ACE Global Markets or its subsidiaries is subject to applicable U.K. insurance laws and regulations. In addition, the release of funds by Syndicate 2488 to subsidiaries of ACE Global Markets is subject to regulations promulgated by the Society of Lloyd's. ACE INA's U.S. insurance subsidiaries may pay dividends, without prior regulatory approval, subject to restrictions set out in state law of the subsidiary's domicile (or, if applicable, "commercial domicile"). Typically, restrictions state that dividends may only be paid from earned surplus (unassigned funds) and are subject to (i) certain limitations based upon the policyholder surplus and/or net income or investment income of the insurer (specific threshold set by state law of insurer's domicile); (ii) total dividends paid during a twelve month period, and (iii) the maintenance of minimum capital requirements. ACE INA's international subsidiaries are also subject to insurance laws and regulations particular to the countries in which the subsidiaries operate. These laws and regulations sometimes include restrictions that limit the amount of dividends payable without prior approval of regulatory insurance authorities.

ACE Limited did not receive any dividends from ACE Global Markets or ACE INA in 2005 and 2004. The debt issued by ACE INA to provide partial financing for the ACE INA acquisition and for other operating needs is serviced by statutorily permissible distributions by ACE INA's insurance subsidiaries to ACE INA as well as other group resources.

Our consolidated sources of funds consist primarily of net premiums written, net investment income and proceeds from sales and maturities of investments. Funds are used primarily to pay claims, operating expenses, dividends and for the purchase of investments. After satisfying our cash requirements, excess cash flows from these underwriting and investing activities are invested.

Our insurance and reinsurance operations provide liquidity in that premiums are received in advance, sometimes substantially in advance, of the time claims are paid. Generally cash flows are affected by claim payments that, due to the nature of our operations, may comprise large loss payments on a limited number of claims and which can fluctuate significantly from period to period. The irregular timing of these loss payments can create significant variations in cash flows from operations between periods. Refer to the section entitled, "Contractual obligations and commitments" for our estimate for future claim payments by period.

Sources of liquidity include cash from operations, routine sales of investments and financing arrangements.

- Our consolidated net cash flows from operating activities were $4.3 billion in 2005, compared with $4.9 billion in 2004. These amounts reflect net income for each period, adjusted for non-cash items and changes in working capital. Net income decreased $125 million in 2005, compared with 2004. Primarily due to the significant catastrophe losses (and related payments) over the last two years, our net losses and loss expenses paid increased to $5.4 billion in 2005, compared with $4.8 billion for the same period in 2004.
- Our consolidated net cash flows used for investing activities were $5.6 billion in 2005 compared with $4.9 billion in 2004. For the indicated periods, net cash flows used for investing activities were related principally to purchases of fixed maturities. Net purchases of fixed maturities were $5.5 billion in 2005, compared with $5.1 billion in 2004. In 2005, net cash flows used for investing activities benefited from the net proceeds of the public offering of approximately $1.5 billion. Net cash flows used for investing activities in 2004, included $959 million from the sale of Assured Guaranty (net of cash sold of $82 million).
- Our consolidated net cash flows from financing activities were $1.3 billion in 2005, compared with consolidated net cash flows used for financing activities of $155 million in 2004. For the current year, cash flows from financing activities increased due to our public offering, and due to an increase in proceeds from the exercise of options for Ordinary Shares.

Although our ongoing operations continue to generate positive cash flows, our cash flows are currently impacted by a large book of loss reserves from businesses in run-off. The run-off operations generated negative operating cash flows of $170 million in 2005, compared with $88 million in 2004.

Both internal and external forces influence our financial condition, results of operations and cash flows. Claim settlements, premium levels and investment returns may be impacted by changing rates of inflation and other economic conditions. In many cases, significant periods of time, ranging up to several years or more, may lapse between the occurrence of an insured loss, the reporting of the loss to us and the settlement of the liability for that

loss. We believe that our cash balances, cash flow from operations, routine sales of investments and the liquidity provided by our credit facilities, as discussed below, are adequate to meet expected cash requirements.

In order to enhance cash management efficiency, during the first quarter of 2006 we entered into an agreement to implement a multi-currency notional cash pooling program with a bank provider. In this program, participating ACE entities (based on regulatory approval) establish deposit accounts in different currencies with the bank provider and, each day, the credit or debit balances in each account are notionally translated into a single currency (US dollars in our case) and then notionally pooled. The bank extends overdraft credit to any participating ACE entity as needed, provided that the overall notionally-pooled balance of all accounts at the end of each day is at least zero. Actual cash balances are not physically converted and are not co-mingled between legal entities. This program is particularly effective during periods of short-term timing mismatches between expected inflows and outflows of cash by currency. ACE entities may incur overdraft balances as a means to address such mismatches, and any overdraft balances incurred under this program by an ACE entity would be guaranteed by ACE Limited (up to $50 million in the aggregate) and classified as short-term debt on our balance sheet. ACE Limited has negotiated a dedicated credit facility to support this program.

ACE and its subsidiaries are assigned debt and financial strength (insurance) ratings from internationally recognized rating agencies, including S&P, A.M. Best, Moody's Investors Service and Fitch IBCA. The ratings issued on our companies by these agencies are announced publicly and are available directly from the agencies. Our internet site, acelimited.com, also contains some information about our ratings, which can be found under the Investor Information tab.

Financial strength ratings represent the opinions of the rating agencies on the financial strength of a company and its capacity to meet the obligations of insurance policies. Independent ratings are one of the important factors that establish our competitive position in the insurance markets. The rating agencies consider many factors in determining the financial strength rating of an insurance company, including the relative level of statutory surplus necessary to support the business operations of the company. These ratings are based upon factors relevant to policyholders, agents and intermediaries and are not directed toward the protection of investors. Such ratings are not recommendations to buy, sell or hold securities.

Debt ratings apply to short-term and long-term debt as well as preferred stock. These ratings are assessments of the likelihood that we will make timely payments of principal and interest and preferred stock dividends.

It is possible that, in the future, one or more of the rating agencies may reduce our existing ratings. If one or more of our ratings were downgraded, we could incur higher borrowing costs and our ability to access the capital markets could be impacted. In addition, our insurance and reinsurance operations could be adversely impacted by a downgrade in our financial strength ratings, including a possible reduction in demand for our products in certain markets.

Capital Resources

Capital resources consist of funds deployed or available to be deployed to support our business operations. The following table summarizes the components of our capital resources at December 31, 2005 and 2004.

(in millions of U.S. dollars)	**December 31 2005**	December 31 2004
Short-term debt	**$ 300**	$ 146
Long-term debt	**1,811**	1,849
Total debt	**2,111**	1,995
Trust preferred securities	**309**	412
Preferred Shares	**557**	557
Ordinary shareholders' equity	**11,255**	9,288
Total shareholders' equity	**11,812**	9,845
Total capitalization	**$ 14,232**	$ 12,252
Ratio of debt to total capitalization	**14.8%**	16.3%
Ratio of debt plus trust preferreds to total capitalization	**17.0%**	19.6%

We believe our financial strength provides us with the flexibility and capacity to obtain funds externally through debt or equity financing on both a short-term and long-term basis. Our ability to access the capital markets is dependent on,